No. 89-1832 (2)

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1989

HEALTHCARE INTERNATIONAL, INC.,
WEST OAKS, INC., HEALTHCARE-BROWN MANAGEMENT CO.,
THE BROWN SCHOOLS, INC., JAMES L. FARISS, JR.,
DAVID L. WHELAN, AND ELLIOTT H. WEIR, JR.
Petitioners,

v.

L&B HOSPITAL VENTURES, INC.,
LEO J. BORRELL, BOBBY R. LOWRANCE,
PSYCHIATRIC ASSOCIATES OF HOUSTON, P.A.,
AND DOUGLAS B. HANSEN,
Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

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RESPONDENTS' BRIEF IN OPPOSITION

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QUESTION PRESENTED

This is a federal securities fraud action brought by the former limited partners of a *bona fide* limited partnership. The district court granted summary judgment and dismissed the lawsuit for lack of subject-matter jurisdiction on the sole ground that plaintiffs' limited partnership interests did not constitute "investment contracts." The court of appeals reversed and remanded, finding that plaintiffs had established specific facts showing a genuine issue for trial. The question presented is whether the court of appeals correctly held that summary judgment should not have been granted against plaintiffs in light of the abundant record evidence showing that defendants controlled the limited partnership and that defendants exploited this control to deny plaintiffs access to material information about the limited partnership.

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STATEMENT OF THE CASE

This lawsuit arises out of defendants' purchase of plaintiffs' 25% ownership interest in West Oaks, The Psychiatric Institute of Houston, Ltd., a Texas limited partnership that owned West Oaks Hospital, a psychiatric facility located in Houston, Texas.[1] Plaintiffs, L&B Hospital Ventures, Inc., Leo J. Borrell, Bobby R. Lowrance, Psychiatric Associates of Houston, P.A., and Douglas B. Hansen, are all doctors (or entities whose principals are doctors) who are former limited partners. Defendants, who collectively manage the business and operations of the hospital, are the general partner (West Oaks, Inc.), its parent company (Healthcare), its affiliates (Brown Schools, Inc. and Healthcare - Brown Management Co.) and its officers (James L. Fariss, Jr., David L. Whelan and Elliott H. Weir, Jr.).

A. The Limited Partnership Agreement And The Management Agreement Gave Defendants Total Managerial Control Over West Oaks Hospital

Douglas B. Hansen, the chief of the child psychiatry department at Baylor University, and three other faculty members, Leo J. Borrell, Bobby R. Lowrance and Edward U. McReynolds (a principal of Psychiatric Associates of Houston, P.A.), saw a need in the mid-1970's for an inpatient treatment facility for children and adolescents in the Houston, Texas area. R. 779, 830-32. The doctors, who knew that they "couldn't do the business parts of it," searched for a partner that could develop the project. R. 717.

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[1] To promote clarity, petitioners shall be referred to herein as "defendants" and respondents as "plaintiffs" or "the limited partners" or "the doctors."

The doctors wanted and needed an experienced partner that could design the hospital, provide for financing, oversee the construction, and administer and manage the hospital and its operations after it was built. R. 717-18, 780-81, 833-34. Defendant James L. Farris, Jr., on behalf of defendant Brown Schools, Inc., approached the doctors about developing the proposed hospital project. R. 779-82. The ensuing discussions led to the formation of a limited partnership. *Id.*

The West Oaks Limited Partnership Agreement was executed on September 29, 1979, by Brown Schools, Inc. and Drs. Lowrance, Borrell and Hansen and Psychiatric Associates of Houston, P.A. R. 869. The general partner, Brown Schools, Inc., owned a 75% interest and managed and controlled the partnership. R. 873. Defendants granted plaintiffs an aggregate 25% ownership interest as limited partners. *Id.*[2]

The Limited Partnership Agreement stated that the limited partnership was being formed pursuant to the Texas Uniform Limited Partnership Act and that the rights and liabilities of the parties would be as provided by that statute. R. 869. Accordingly, the limited partners' liability for any partnership debts was limited to the amount of the limited partners' initial capital contributions. R. 877-78. The limited partners could not dissolve the partnership. R. 896. Most importantly, the agreement prohibited the limited part-

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[2] The limited partnership was originally called Psychiatric Institute of Houston, Ltd. and the general partner was Brown Schools, Inc. The Limited Partnership Agreement was later amended to substitute defendant West Oaks, Inc. as general partner and the partnership's name was changed to West Oaks, the Psychiatric Institute of Houston, Ltd.

ners from exercising any management powers. It expressly stated that "[t]he Limited Partners shall not participate in the management or control of the Partnership's business nor shall they transact any business for the Partnership, nor shall they have the power to act for or bind the Partnership, said powers being vested solely and exclusively in the General Partner." R. 877.

The Limited Partnership Agreement provided that the general partner "shall have exclusive authority to manage the operations and affairs of the Partnership and to make all decisions regarding the business of the Partnership." R. 878. It granted the general partner "the right, power and authority to do on behalf of the Partnership all things which, in the General Partner's sole judgment, are necessary, proper or desirable to carry out the aforementioned duties and responsibilities." *Id.* Two such powers are especially relevant to this lawsuit. First, the general partner retained the sole discretion to determine how much partnership cash to budget for reserves and how much to distribute to the limited partners as profits. R. 872-73. Second, the general partner possessed the sole discretion to lease, sell or refinance any partnership property. R. 878-79.

On September 29, 1979 (the same date as the Limited Partnership Agreement), Brown Schools, Inc., as general partner, signed a Management Agreement with Brown Schools, Inc., as manager. R. 588. The Management Agreement provided that Brown Schools, Inc., through a Hospital Administrator, shall "manage all aspects of the operation of the Hospital, including but not limited to staffing, accounting, billing, collections, setting of rates and charges and general admin-

istration." R. 590. In addition, it authorized Brown Schools, Inc. to prepare, for each fiscal year, a capital expenditures budget, an operating budget, and a projection of cash receipts and disbursements. R. 595-96.

In September 1981, two full years after the signing of the Limited Partnership Agreement and the Management Agreement, West Oaks Hospital opened and began admitting patients. Defendant Healthcare International, Inc. ("Healthcare") employed Kay E. Peck to act as Hospital Administrator.[3] Ms. Peck testified unequivocally that, as Hospital Administrator, "I ran the hospital." R. 106. She reported to Jean Smith, Healthcare's Vice President for Psychiatric Operations. R. 93. Together, they determined "the operations of the hospital, contracts, financial status, budgets, staffing" and all other important matters. R. 94-95.

Healthcare itself exercised direct control over many crucial aspects of the hospital's operations. Ms. Peck testified, for example, that "the corporate office" controlled the hospital's capital expenditures, debt incurrence, and the amount and frequency of the limited partners' profit distributions. R. 106. Healthcare's control over the hospital's operations was so tight that any expenditure over $500 required its prior approval. R. 103-04. In addition, Healthcare took direct responsibility for handling the hospital's insurance coverage and labor union matters, and for purchasing the hospital's supplies, drugs, equipment, furnishings, materials and services. R. 97, 99.

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[3] Healthcare is the parent company of all the defendant corporations. The individual defendants, James L. Fariss, Jr., David L. Whelan and Elliott H. Weir, Jr., serve as the top officers and directors for all the defendant corporations.

Defendants made certain that, in accordance with the Limited Partnership Agreement, the limited partners did not participate in the hospital's management. As Dr. Borrell testified, defendants "want[ed] to make sure that we remained limited partners and not involved in the day-to-day operations." R. 508. He specifically recalled that defendants "told us as limited partners we did not have a right or obligation nor would they allow us to participate in day-to-day operations." R. 512-13.

Dr. Lowrance confirmed that the limited partners had no control over the managerial decisions of the partnership; no control over the expenses incurred by the limited partnership; no control over the capital expenditures made by the partnership; and no authority to incur any debt on behalf of the partnership. R. 548-49. He testified further that the limited partners depended on defendants' managerial and financial expertise to operate the partnership. R. 549.

Dr. Hansen corroborated these facts. R. 523-526. He confirmed that Healthcare determined the amount and frequency of partnership cash distributions, R. 525, and the amount the hospital charged patients for the medical services rendered by the limited partners. R. 526.

B. Defendants Controlled West Oaks Hospital's Clinical Affairs

The limited partners, as doctors, treated patients at West Oaks Hospital and served on the Hospital Credentials Committee and the Continuing Education Committee. But the hospital's clinical business, like all its business, was controlled by defendants. The general partner, West Oaks, Inc., adopted a resolution

on August 19, 1981 (just weeks before West Oaks Hospital opened), creating a Governing Body known as the Board of Directors and appointing defendants' own officers and employees as the sole voting members. R. 488. The Board of Directors controlled "all aspects of the medical and administrative management of the Hospital." R. 491. It was "the final authority in all Hospital and Medical Staff matters" and could "overturn any decision of the Medical Staff." R. 490. Kay Peck, the Hospital Administrator and a full-fledged member of the Board, confirmed that it was the Board's responsibility to "[s]et policy and review the operations of the hospital" and "approve the actions of the medical staff." R. 48.[4]

Defendants signed on December 12, 1979, a Clinical Advisory Agreement with a professional corporation operated by Drs. Lowrance and Borrell. R. 907. It gave defendants the right to "institute, terminate or change in any material respect any Hospital clinical program" by giving the doctors prior notice. R. 909. Drs. Lowrance and Borrell, in contrast, could only "recommend" and "consult" with defendants about "clinical issues" and "clinical programs." R. 908. Defendants unilaterally terminated the Clinical Advisory Agreement effective December 12, 1985. R. 615.

Defendants also signed on December 12, 1979, a Children's Programs Clinical Agreement with a

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[4] Two plaintiffs, Drs. Lowrance and Hansen, as well as Dr. McReynolds, held ex-officio positions at various times on the Board. Oddly, the Hospital Administrator could not "remember" at deposition whether these doctors had a vote. R. 48-49. As non-voting members, plaintiffs' positions on the Board gave them no control over the hospital's clinical affairs.

professional association operated by Dr. Hansen. R. 917. It provided that Dr. Hansen shall perform the "clinical services" necessary to operate the children's program at the hospital. R. 918. Like the Clinical Advisory Agreement, defendants expressly reserved the right "to discontinue or change" the children's program. R. 919.

Defendants entered into another agreement with Dr. Hansen, effective June 1, 1985 (nearly four years after West Oaks Hospital opened), whereby he served as the hospital's Medical Director. R. 949. The agreement provided that Dr. Hansen "shall report to and be under the direction of the administrator of Hospital." R. 951. The other limited partners held subordinate Unit Medical Director positions on comparable terms.

The Medical Director position was subject to the Clinical Advisory Agreement, which gave defendants the right to "terminate or change in any material respect the authority or duties of the Medical Director" on prior notice. R. 909. In addition, the Clinical Advisory Agreement gave defendants the right to terminate the Medical Director on prior notice. R. 908. It also provided that the hospital shall not hire any Medical Director not approved by the doctors and shall terminate any Medical Director on prior notice from them. *Id.* This power was limited by another agreement between the parties which provided that the doctors shall have the right to review and approve the hiring of the Medical Director only "[s]o long as such actions do not adversely affect Doctors' status as limited partners." R. 823.

Kay Peck, the Hospital Administrator, acknowledged that the limited partners lacked "clinical con-

trol." R. 105. She recalled that the limited partners often told defendants that they "wanted to be on the management committee and the Board and the long-range planning committee of the hospital and HII [Healthcare]. And they wanted to be in charge of professional staff relationships and they wanted to supervise all AHP's [Allied Health Professionals], nurses, and admitting staff." R. 102. Defendants refused the limited partners' demands, including voting membership on the Board of Directors which controlled all medical and staff matters, because "[t]hat was not a good idea." *Id.* Ms. Peck admitted that she "couldn't permit that as administrator." R. 105.

C. Defendants' Own Records Show That The Limited Partners Admitted A Small And Steadily Decreasing Percentage Of Patients To West Oaks Hospital

Plaintiffs contributed to West Oaks Hospital's success "[b]y working hard as doctors and doing good patient care," and by advising the hospital on its clinical programs and related matters. R. 791. In addition, plaintiffs contributed to the hospital's revenues to the extent they admitted patients there for treatment.

The doctors speculated at deposition about the percentage of the hospital's revenues they generated through patient admissions. R. 789-90, 931. That testimony was uninformed (and erroneous) guesswork, however, inasmuch as the hospital management had always withheld this information from the limited partners. Dr. Borrell made this clear when defendants' counsel interrogated him:

Q: Are the percentages that you have given me, the 30 to 50 percent, is that what you believed were your contribution to the revenues?

A: No. That's what I'm saying. . . . We were asking for that information and the hospital would not give us that information. . . . And they took the position that was really not information that limited partners had privy to.

Q: Did they say why you weren't, as limited partners, entitled to that information?

A: They said that was the operations of the hospital. Because we were limited partners, we didn't have any rights to have information which they decided we shouldn't have regarding the operations. . . . R. 509-11.

In contrast, defendants themselves compiled West Oaks Hospital's admissions statistics in February 1986 (a few weeks before defendants purchased plaintiffs' limited partnership interests). R. 58&60, R. 642-44. Those statistics, taken from the hospital's own records, show the exact percentage of admissions attributable to the doctors during the four full years that they held limited partnership interests:

	1982	1983	1984	1985
Hansen	0%	0%	0%	0%
Borrell	12%	7%	8%	3%
Lowrance	8%	5%	4%	1%
Parikh	8%	7%	6%	3%
Boylston	4%	[illegible]%	.50%	1%
Olsson	0%	0%	0%	.60%
Bohnn	1%	.33%	.25%	0%

These figures show that the percentage of patient admissions attributable to the limited partners was small at the start, became smaller, and eventually became negligible. In sum, the doctors made a small and steadily decreasing contribution to the hospital's success.

D. Defendants' Total Control Over The West Oaks Limited Partnership Enabled Them To Defraud The Limited Partners By Denying Them Access To Material Information About The Hospital

Defendants' control over West Oaks Hospital grew increasingly hostile throughout 1985. Defendants advised Drs. Lowrance and Borrell on September 12, 1985, that the hospital was exercising its right to unilaterally terminate the Clinical Advisory Agreement. R. 615. In addition, the limited partners had longstanding concerns about the way the general partner was managing the hospital's finances. Defendants refused the limited partners' repeated requests to distribute more profits or to refinance the hospital to make more cash available. R. 532-34, 536-40.

The parties held meetings throughout January-March, 1986, to discuss these problems. The outcome was that defendants offered to purchase the doctors' limited partnership interests. Defendants, who controlled the management and operations of the hospital at all times, provided the limited partners with virtually no financial information at these meetings. R. 229.

The terms and conditions of the purchase transaction are set forth in the counterpart Agreements For Sale And Assignment Of Limited Partnership In-

terest In West Oaks, The Psychiatric Institute of Houston, Ltd., each dated March 21, 1986. R. 137. The parties to the Agreements For Sale are the limited partners and the self-styled "Healthcare Group": defendants Healthcare, Healthcare-Brown Management Company, and West Oaks, Inc. The sale agreements provided that defendants shall pay a total of $12 million for the limited partners' aggregate 25% ownership interest in West Oaks Hospital.

The $12 million purchase price for the limited partners' 25% interest indicates a $48 million overall value for the hospital. The doctors did not, and could not, know whether $12 million was a fair price, however, because, as limited partners excluded from the hospital's management and denied access to essential information, they did not know the hospital's value. Therefore, the limited partners insisted that defendants include the following representation and warranty in the sale agreements:

> *Disclosure.* The Healthcare Group has disclosed to [the limited partners] all material information regarding the Partnership, its operations and [the limited partners'] Ownership Interest." R. 150.

The sale agreements expressly stated that the limited partners are "relying" on this particular representation and warranty being "true and correct." R. 158. At the closing on March 28, 1986, defendants certified that the representation and warranty of full disclosure that the Healthcare Group had made in the sale agreements remained true as of that date. R. 169.

In fact, as the limited partners later learned, defendants' representation and warranty was false

when it was made (as was the certification). The record shows that, in November 1985, defendants began secretly considering the formation of a real estate investment trust ("REIT") called HealthVest, a financing vehicle which involved the sale-and-leaseback of several Healthcare facilities, including West Oaks Hospital. R. 171. Defendants had already commissioned an appraisal by Valuation Counselors, the nation's leading hospital valuation firm, that showed, as of October 31, 1985, that West Oaks Hospital had an $88,207,000 business enterprise value. R. 172, 177. The Valuation Counselors' report defined "business enterprise value" as "what a prudent investor would be willing to pay for ownership of [the] business enterprise." R. 176.

The record further reveals that, on March 3, 1986 (three weeks before the parties closed the Agreements For Sale), defendants submitted to Smith Barney, Harris Upham & Company, the REIT underwriter, a five-year forecast for West Oaks Hospital's operations which projected steadily increasing revenues and earnings. R. 179. Defendants provided these same financial projections to Valuation Counselors, which used them to prepare an updated appraisal that showed, as of March 14, 1986 (two weeks before the parties closed the Agreements For Sale), that West Oaks Hospital had an $84 million business enterprise value. R. 189, 191. Ray Moore, Valuation Counselors' executive vice-president, testified that Valuation Counselors could not have made an accurate appraisal of West Oaks Hospital's value without the financial projections defendants had provided him, but had concealed from the limited partners during the negotiations. R. 248-49.

It is undisputed that defendants did not disclose the REIT, the financial projections or the two appraisals to the limited partners prior to the March 28, 1986, closing of the sale agreements. R. 223, 225, 253-55, 259-61, 266. Accordingly, plaintiffs did not suspect they had been cheated until defendants later issued a prospectus in connection with HealthVest's initial public offering. The prospectus, which defendants filed with the Securities Exchange Commission on May 29, 1986, expressly incorporated the March 14, 1986, appraisal by Valuation Counselors that valued West Oaks Hospital at $84 million. R. 205-07. Plaintiffs thereafter commenced this action.

SUMMARY OF ARGUMENT

The federal securities laws are meant to protect investors who cannot protect their own interests in a venture because they are excluded from its management. The courts presume that limited partners are protected by the federal securities laws because limited partners generally lack management power and control.

Here, the district court granted defendants' motion for summary judgment and dismissed the case for lack of subject-matter jurisdiction on the sole ground that plaintiffs' West Oaks limited partnership interests did not constitute "investment contracts." On appeal, the Fifth Circuit reversed and remanded, finding that "the plaintiffs have established specific facts showing a genuine issue for trial." App. at A7. Defendants' petition for a rehearing *en banc* was denied.

This case warrants no further review. First, it was correctly decided. The district court plainly erred in

disregarding the abundant record evidence showing that defendants alone managed and controlled the limited partnership. Second, the test applied by the court of appeals—a gloss on the *Howey* test—does not pose a conflict among the federal courts. Indeed, the court of appeals has applied the same test for the past fifteen years and this Court has never taken exception. Third, this case turns solely on its facts. The court of appeals specifically identified seven triable issues raised by plaintiffs' evidence. App. at A5-A7.

ARGUMENT

I. The Court of Appeals' Decision Does Not Conflict With This Court's Prior Decisions

Defendants assert that the court of appeals' decision conflicts with this Court's prior decisions. This contention is without merit.

A. The "Managerial Efforts" Test Applied By The Court Of Appeals Does Not Conflict With Any Of This Court's Prior Decisions

The Securities Exchange Act of 1934, 15 U.S.C. § 78 c(a)(10), defines the term "security" to include investment contracts. This Court, in *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298 (1946), stated that an investment contract was "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or a third party."

All the courts of appeal agree that, in light of the remedial nature of the federal securities laws and the statutory policy of affording broad protection to the public, the word "solely" in the *Howey* test should not be read as a strict or literal limitation. *See, e.g.*,

Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc., 840 F.2d 236, 240 n.4 (4th Cir. 1988) (collecting cases). The Fifth Circuit, in particular, has long interpreted the *Howey* test to mean that an investment contract exists where "the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise." *See SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473, 483 (5th Cir. 1974); *accord, SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973).

The "management efforts" test, which the court of appeals applied in this case, does not conflict with *Howey*. To the contrary, as this Court recognized in *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 852 (1975), the touchstone of the *Howey* test is "an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others." In short, the court of appeals' test is nothing more than a gloss on the basic *Howey* test.

Defendants' focus is not really on the test applied in this case, but rather the test *as* applied in this case. Defendants assert there was "overwhelming and undisputed evidence" that plaintiffs had substantial control over the hospital's operations and made substantial contributions to its success. Pet. at 12. The court of appeals, however, concluded otherwise based on its review of the record. It specifically identified *seven* triable issues raised by plaintiffs' evidence showing:

> (1) that the Limited Partnership Agreement gave defendants sole control of the hospital;

(2) that defendants excluded the limited partners from participating in the hospital's day-to-day operations;

(3) that defendants did not give the limited partners any access to business or financial information about the hospital's operations;

(4) that defendants did in fact control the hospital to the exclusion of the limited partners;

(5) that the Management Agreement specified that operational control resided with defendants;

(6) that defendants' own admissions figures reveal that plaintiffs made a meager contribution to the hospital's success; and

(7) that the Hospital Administrator confirmed that defendants alone ran the hospital.

App. at A5-A7. In view of all this evidence showing that defendants alone managed and controlled the partnership's business, the court of appeals correctly concluded that the summary judgment should not have been granted.

B. Defendants Did Not Rebut The Presumption That Plaintiffs' Limited Partnership Interests Are Securities

The fact that West Oaks Hospital operated at all times as a *bona fide* limited partnership is sufficient reason, in itself, to deny defendants' petition. Generally, the courts presume that limited partnership interests are investment contracts. *See, e.g., William-*

son v. Tucker, 645 F.2d 404, 423-24 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981); *SEC v. Murphy*, 626 F.2d 633, 640-41 (9th Cir. 1980); *Hirsch v. Dupont*, 396 F. Supp. 1214, 1227 (S.D.N.Y. 1975), *aff'd*, 553 F.2d 750 (2nd Cir. 1977). Limited partners need the protections of the federal securities laws because they have "little or no authority to take an active part in the management of the partnership." *Youmans v. Simon*, 791 F.2d 341, 346 (5th Cir. 1986); *see also Gordon v. Terry*, 684 F.2d 736, 741 n. 5 (11th Cir. 1982) ("Limited partnership interests are generally held to be securities interests because the limited partners have no voice in management decisions").

Defendants now "suggest"—for the first time in this litigation—that West Oaks Hospital was not a *bona fide* limited partnership. Pet. at 14. This suggestion is without merit. To rebut the presumption that plaintiffs' limited partnership interests are securities, it was necessary for defendants to prove that plaintiffs actively participated in the management and control of West Oaks Hospital. Defendants did not, and could not, meet this burden.[5]

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[5] The courts—including the Fifth Circuit—will uphold a summary judgment dismissing a federal securities law action for lack of subject-matter jurisdiction where the record shows that the limited partnership was a sham or the limited partners controlled the venture's management. *See, e.g.*, Gordon v. Terry, 684 F.2d at 741 n.5; Frazier v. Manson, 484 F.Supp. 449 (N.D.Tex. 1980), aff'd, 651 F.2d 1078 (5th Cir. 1981). But here, defendants never once contended that the West Oaks limited partnership did not operate as a *bona fide* limited partnership, nor that plaintiffs acted as *de facto* general partners, nor that plaintiffs should forfeit the limited liability normally accorded to limited partners.

The question whether a limited partnership interest is an investment contract depends, in the first instance, on an examination of the limited partnership agreement itself. *Youmans v. Simon*, 791 F.2d at 346-47; *Williamson v. Tucker*, 645 F.2d at 424 & n. 14. An examination of the way the West Oaks Limited Partnership Agreement distributed management power and control proves, beyond any doubt, that it was an investment contract.

First, the West Oaks Limited Partnership was formed pursuant to the Texas Uniform Limited Partnership Act. R. 869. Limited partnerships formed in accordance with a state's limited partnership act are considered investment contracts "as a matter of law." *Goodman v. Epstein*, 582 F.2d 388, 397, 406-08 (7th Cir. 1978), *cert. denied*, 440 U.S. 939 (1979). The reason is that the limited partnership statute itself prohibits the limited partners from taking part in the management of the venture. *Hirsch v. DuPont*, 396 F.Supp. 1214, 1227 (S.D.N.Y. 1975), *aff'd.*, 553 F.2d 750 (2d Cir. 1977) (citing parallel New York statute). Defendants here did not argue, and there is no evidence to show, that the West Oaks Limited Partnership violated any aspect of the Texas limited partnership statute.

Second, the West Oaks Limited Partnership Agreement contained all the requirements for a genuine limited partnership. The limited partners' liability for the partnership's debts was limited to the amount of the limited partners' initial capital contributions. R. 877-78. The limited partners could not work a dissolution of the partnership. R. 896. Most importantly, the agreement strictly prohibited the limited partners from exercising any management powers. It expressly

provided that "[t]he Limited Partners shall not participate in the management or control of the Partnership's business, . . . said powers being vested solely and exclusively in the General Partner." R. 877.

Third, the West Oaks Limited Partnership Agreement vested "the exclusive authority to manage the operations and affairs of the Partnership and to make all decisions regarding the business of the Partnership" in the defendant general partner. R. 878.

Fourth, the West Oaks Limited Partnership Agreement gave the general partner the sole discretion to determine how much partnership cash to budget for reserves and how much to distribute to the limited partners as profits. R. 872-73. It also gave the general partner the sole discretion to lease, sell or refinance any partnership property. R. 878-79.

Finally, the Management Agreement provided that defendants shall "manage all aspects of the operation of the Hospital." R. 590. The Hospital Administrator, Kay E. Peck, testified that "I ran the hospital" subject to Healthcare's close supervision. R. 106. The doctors' deposition testimony confirmed that defendants actually did control the hospital. R. 508, 512-13, 523-26, 548-49.

The court of appeals specifically cited this evidence in its decision. App. at A5-A7. Defendants simply ignore it. Since the record shows that West Oaks Hospital operated as a *bona fide* limited partnership, plaintiffs' limited partnership interests should be treated as securities as a matter of law.

C. Defendants, Who Own and Operate Twenty-Three Healthcare Facilities, Were The Promoters of West Oaks Hospital

Defendants describe plaintiffs (Drs. Lowrance, Borrell and Hansen), together with Dr. McReynolds, as the "promoters" of West Oaks Hospital. Pet. at 3-6. They note that, between 1976-1979, the doctors contacted various healthcare management companies, incurred professional fees, and filed a certificate of need in connection with a visionary hospital project.

Promoters, for purposes of the federal securities laws, are those individuals whose efforts result in "the organization of a business" and without whose efforts "the investments would be virtually worthless." *Bender v. Continental Towers Limited Partnership*, 632 F.Supp. 497, 501 (S.D.N.Y. 1986). The record shows that it is defendants, and not plaintiffs, who fit this definition.[6]

Plaintiffs' idea for a psychiatric hospital for children and adolescents remained just that—a "notion"—until defendants approached the doctors and, in September 1979, formed the West Oaks limited partnership. R. 713. Until then, the doctors had not made any progress toward the realization of the hospital project; to the contrary, as defendants note, they faced the loss of $120,000 in sunk costs. All plaintiffs had after spending three years and much money was the same dream they had when they started.

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[6] Defendants never define the term "promoter." Instead, they cite a long passage from Reves v. Ernst & Young, 58 U.S.L.W. 4208 (1990), addressing the question whether a demand note should be treated as a security. Reves has no bearing on this case: indeed, the Court stated there that "the Howey test is irrelevant to the issue before us today." Id. at 4211 n.4.

Even the district court recognized that the doctors "wanted and needed" an experienced partner that could design the hospital, acquire the land, arrange for financing, oversee the construction, and administer and manage the hospital and its operations after it was built. R. 8; *see also* R. 717-18, 833-34, 780-81. It was defendants who provided all those essential services with respect to West Oaks Hospital and made it a viable enterprise. Indeed, the June 19, 1979, letter of intent between plaintiffs and defendants specifically stated that "Brown will be responsible for arranging financing, developing and operating the Hospital." R. 823.

Defendants are a large and aggressive healthcare enterprise which owns and operates 23 facilities across the country. R. 263-64. As general partner, defendants did what the doctors could not do—organize West Oaks Hospital. It was defendants who promoted West Oaks Hospital to the limited partners.

D. The Court Of Appeals' Decision Is Not Contrary To This Court's Established Summary Judgment Principles

Defendants assert that the court of appeals' decision is contrary to the summary judgment principles set forth in *Celotex Corp. v. Catrett*, 477 U.S. 317 (1986), because plaintiffs allegedly failed to come forward with any probative evidence on the investment contract issue. This contention utterly ignores the record.

The court of appeals expressly recognized that this case was governed by *Celotex*. App. at A3. Applying the *Celotex* standard, the court of appeals specifically identified seven triable issues of fact raised by

plaintiffs' evidence. *Id.* at A5-A7. In view of this evidence, the court of appeals correctly concluded that the summary judgment should not have been granted.

II. The Court Of Appeals' Decision Does Not Conflict With Other Federal Courts' Holdings

Defendants assert that the court of appeals' decision conflicts with other federal courts' holdings. These alleged conflicts do not exist.

A. Plaintiffs Did Not Possess The Ability To Control The West Oaks Limited Partnership

Defendants rightly commend the court of appeals' decision in *Williamson v. Tucker*, 645 F.2d 404 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981), for its "thoughtful analysis of the application of *Howey* to partnership interests." Pet. at 21-22. They mistakenly assert, however, that the court of appeals' decision in this case conflicts with the principles laid down in *Williamson*.

The court of appeals' decision in this case was plainly guided by *Williamson*. In fact, just like defendants, the court of appeals commended *Williamson* for its "thoughtful" analysis. App. at A5. In particular, it cited *Williamson* for the proposition that the federal securities laws do not protect investors who retain "control"—i.e., "the power over the investment and the access to information about it which is necessary to protect against any unwilling dependence on the manager." *Id.* Applying this standard, the court of appeals then proceeded to identify the specific evidence plaintiffs had presented showing that the limited partners *lacked* this control. *Id.* at A5-A7. Therefore, defendants' assertion that there is "no dispute" that plaintiffs possessed meaningful powers ig-

nores both the court of appeals' opinion and the record. Pet. at 22.

Furthermore, the facts which gave rise to this lawsuit show that defendants used their control over West Oaks Hospital to defraud the limited partners. First, defendants refused the limited partners' repeated requests to distribute more profits or to refinance the hospital. Then defendants terminated the Clinical Advisory Agreement. Faced with these increasingly hostile management actions, the doctors decided to accept defendants' offer to purchase their limited partnership interests. What the doctors did not (and could not) know, however, was that defendants had concealed the following material information during the negotiations: (i) that defendants planned to sell West Oaks Hospital to a real estate investment trust they had secretly formed; (ii) that defendants had prepared a forecast of the hospital's operations which projected steadily increasing revenues and earnings for the 5-year period following the sale of plaintiffs' limited partnership interests; and (iii) that defendants had commissioned two independent appraisals that valued West Oaks Hospital at $84-$88 million, some $40 million more than defendants led the limited partners to believe the hospital was worth.

Plaintiffs had access to none of this information because defendants had excluded them, as limited partners, from the management and control of the hospital. It is precisely these facts, which illustrate defendants' total control over West Oaks Hospital, which reveal the "economic reality" of the West Oaks limited partnership. *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).

B. No Court Of Appeals Has Rejected The Managerial Efforts Test

Defendants assert that other federal courts have rejected the managerial efforts test. Pet. at 23. They rely especially on *Maritan v. Birmingham Properties*, 875 F.2d 1451 (10th Cir. 1989).

The Tenth Circuit did not reject the managerial efforts test in *Maritan*. To the contrary, it reiterated that the managerial efforts test has been the rule in the Tenth Circuit since *Crowley v. Montgomery Ward & Co.*, 570 F.2d 875, 877 (10th Cir. 1975). The court added, however, that the test should be applied mindful that "[t]he principal purpose of the securities act is to protect investors by promoting full disclosure of information necessary to informed investment decisions." 875 F.2d at 1457, *quoting Matek v. Murat*, 862 F.2d 720, 728 (9th Cir. 1988). Therefore, the focus should be on "access to information about the investment" as well as "managerial control." *Id.* The court stated that "the terms of governing agreement" between the parties was a critical factor in making these determinations. *Id.* at 1458; *see Kline Hotel Partners v. Aircoa Equity Interests, Inc.*, 725 F.Supp. 479, 481 (D.Colo. 1989) ("The Tenth Circuit has joined other circuits in focusing on access to information as well as managerial authority").

The court of appeals' analysis in this case comports in every respect with *Maritan's* gloss on the management efforts test. Here, as mentioned earlier, the court of appeals recognized that the key factor in applying the managerial efforts test was whether the limited partners had "the power over the investment and the access to information about it which is necessary to protect against any unwilling dependence

on the manager." App. at A5, *quoting Williamson v. Tucker*, 645 F.2d at 424. Furthermore, the court of appeals paid special attention to the terms of the Limited Partnership Agreement and the Management Agreement, which gave defendants sole control over the partnership and information about the partnership. App. at A5-A7.

Another case defendants rely on heavily is *Inforex Corp., N.V. v. MGM/UA Entertainment Co.*, 608 F.Supp. 129 (C.D. Cal. 1984). There, the district court held that the percentage-of-the-profits clauses in the agreements signed by actor Sean Connery in connection with several James Bond films should not be treated as investment contracts. The district court said that its holding was limited to those particular facts: "The Court is simply stating that performing the role of James Bond in James Bond films is as undeniably significant to the films' success or failure as the production, distribution, or marketing of the films." *Id.* at 133. The district court's broader view—that "any active participation directed toward securing the profitability of the venture" disqualifies an agreement as an investment contract—finds no support in the case law. *Id.* To the contrary, the courts generally agree that investors who contribute to a venture's success may invoke the protections of the federal securities laws so long as they do not control its management. *See SEC v. Koscot Interplanetary, Inc.*, 497 F.2d at 480-83 (collecting and discussing cases); *see also Landreth Timber Co. v. Landreth*, 471 U.S. 681, 693 (1985) ("we cannot agree . . . that the Acts were intended to cover only 'passive investors' "). In short, the *Inforex* decision cannot serve

as the basis for a perceived conflict among the federal courts on this issue.

C. The Court Of Appeals' Decision Does Not Conflict With The Test Applied By Other Federal Courts

Defendants assert that the test generally applied to determine whether an investment contract exists was "best stated" in *Bailey v. J.W.K. Properties, Inc.*, 703 F.Supp. 478, 480 (W.D.Va. 1989). Pet. at 26. Putting aside the question whether *Bailey* deserves the preeminence defendants confer upon it, the fact remains that the district court in *Bailey* and the court of appeals here undertook exactly the same analysis.

The district court in *Bailey* correctly observed that, in determining whether plaintiffs' interests should be treated as investment contracts, "the dispositive issue is what control plaintiffs had and could have exercised." *Id.* at 480. The court stated that it must focus on "the management contract which structured the rights of the parties in this venture." *Id.* The parties' allocation of "the power to make or control significant decisions" was the key factor in determining which party had "the ultimate control." *Id.* at 494, 495.

Once again, the court of appeals in this case undertook exactly the same inquiry. It too stated that the key factor was whether plaintiffs retained "ultimate control"—i.e., "the power over the investment and the access to information about it which is necessary to protect against any unwilling dependence on the managers." App. at A5, *quoting Williamson v. Tucker*, 645 F.2d at 424. In making this determination, the court of appeals focused primarily on the Limited Partnership Agreement and the Manage-

ment Agreement. It observed that these agreements gave defendants the sole control over the partnership and sole control over information about the partnership. *Id.* at A5-A6. It observed further that plaintiffs' deposition testimony confirmed that the hospital was in fact operated in accordance with these agreements. *Id.* Finally, it observed that the Hospital Administrator testified that defendants controlled the hospital. *Id.* at 7. In view of this evidence, the court of appeals correctly concluded that plaintiffs had established specific facts showing a genuine issue for trial. *Id.*

CONCLUSION

The Court should deny the petition for a writ of certiorari. This case should proceed to trial.

Respectfully Submitted,

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